COVER STORY

SUCCESSION PLANNING

By Joel Sinkin and Terrence Putney, CPA

YOU HAVE DEVOTED years to building a practice. With proper planning, you can maximize the value of your firm through a sale where everyone wins: you, your clients and the successor firm.

The basic concept: How do accounting firms, especially smaller ones, attract and retain their clients? Most people assume all CPAs are competent. Your clients chose you and stay with you primarily because of chemistry, your style and their trust in you. Your staff, location, level of fees and types of services you offer also are important. Your clients value these intangibles of your practice.

Understanding this is a key aspect of succession planning. Even though you sell your practice, and therefore your client list, your clients make the final decision if they will move to the successor firm. Knowing why you have your clients will help you successfully transfer those relationships to a successor and capture the value in your practice.

Starting the process: There are many issues that influence the timing of succession planning. One critical factor is the frequency of interaction with your clients. The less frequently you see your clients, the sooner you must start your transition and succession plan to capture full value. However, as is explained later in this article, starting your transition does not have to mean you will give up your control or reduce your earnings.

The partners in many practices see a substantial number of their clients only once a year. Many clients drop off records, work primarily with staff during the year, or are simply annual business or individual clients. If a partner is five years away from reducing his or her role, that may mean only five visits with many of their clients — five opportunities to complete a positive transition.

The general rule of thumb is to start planning five years prior to when you, or a partner, plan to start transitioning. One way to accomplish this is by affiliating with your successor in advance of your planned phase-out. A technique called a "two-stage deal" allows you to maintain your earnings, come and go as you see fit, have back-up support, and have a deal in place that will allow you to retire when you are ready. This technique can be used with an internal successor, as well as an external successor firm, or even a combination of the two. Your practice has its greatest value when you are still around to assist in the transition and when it is running at top efficiency — not when you are forced into succession with inadequate planning.

Choosing your successor: The key is to look for a successor (partner or new firm) that will provide the greatest continuity in servicing your clients. If location is important, find a successor in close proximity to you. Fee structure and staff servicing the clients should remain as constant as practical. In a two-stage deal, you practice at, or with, the successor for at least a short time after the affiliation. This automatically provides positive endorsement for the successor, which is what most clients are looking for. By the time you reduce your role, clients will have had an opportunity to become acclimated to the successor and vice versa, enhancing continuity and retention.

If your clients require special expertise, look to affiliate with a successor that has this same expertise. You should analyze your role and the quantity and quality of your time, especially client service time. If you have staff that will not be retained by the successor, the same analysis should be done for them. Confirm that the successor either has the excess capacity to replace that time and those roles or the ability to find that capacity. Keep in mind that a well-run firm normally doesn't have a lot of

excess capacity available, but knows how to hire to expand.

Determine what the successor's business plan is for integrating your clients into their practice. Find out what partners or staff will be assigned to your clients. If a partner will be assigned, look at their other responsibilities and determine whether your clients will fit into their current role.

If your potential successor has done a deal like this before, how did it work? Ask what their retention rate is for existing clients. If they have trouble retaining their own clients, why would you think they could retain yours? Consider what sort of reputation the successor has in the community. Investigate any legal or ethical problems.

Perhaps the most important factor in selecting a successor is chemistry. Think about your impressions from your initial meetings with them. Do you enjoy being around them? If you are not comfortable with them, your clients and staff may have the same concern and retention will be a problem.

Determining your practice's value: Many accountants express value for their firm only in terms of a multiple of revenues and compare deals strictly on that basis. However, most firms with less than $2 million in annual fees sell for a price based on an interrelationship between the following five variables:

- Cash up front
- Profitability of the deal for the buyer
- The amount of client retention risk assumed by the buyer
- The length of the payout period
- The multiple of revenues

The multiple is a result of the other factors. They normally are related as follows: A higher down payment often results in a lower multiple. The more profitable the deal is for the buyer because of tax treatment and operating synergies, the higher the multiple because the buyer is more motivated to make a lucrative offer. The less risk the buyer takes that the clients stay after the sale — such as through a deal based on collections — the higher the multiple should be. The longer the payout period, the higher the multiple.

Here's an example: A successor firm can acquire a practice within its current infrastructure with practically no incremental increases in overhead. Therefore, it is expected that the acquisition will be very profitable. How would the above variables affect the valuation?

Assume the seller is willing to accept no cash down, a payout based on 1.75 percent of gross collections over 10 years from the seller's original clients, and the deal is structured as a consulting agreement. Many successor firms would agree to this deal even though they are paying a multiple of 1.75 times revenue.

Now the seller says, he or she wants to be paid out over five years, 25 percent cash down, part goodwill and part currently deductible, and a retention clause so that clients lost after two years have no effect on the price. Depending on the market you are in, many successors would reduce the multiple in this offer to approximately 1.00 to 1.25 times revenue.

If the seller wanted all cash at closing, no adjustment for client retention and an asset allocation primarily to goodwill, many successors would be very reluctant to pay even 1.00 times revenue. As you can see, the pricing multiple is determined by a combination of all the variables. There are other factors that can influence the price, such as the quality of the office equipment, the nature of the clients, level of fees charged, growth potential and staff quality.

When pricing your practice, remember this: People typically do not buy businesses to lose money! Make sure your price and terms will result in profit and positive cash flow for a buyer or you might have difficulty selling your practice for the terms you expect.

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Making the buyer accountable: If your payout is based in part on client retention, consider limiting the successor's ability to raise fees for comparable services during the adjustment period. Have language to preclude the successor from cherry picking the best clients and running off the less desirable ones. Require that the successor respond appropriately to service problems and make his or her best effort to retain clients.

Your practice may be the most valuable asset you own. The most important step may be hiring an expert with substantial experience specific to the accounting industry to guide you through the process of choosing the right successor, valuing and structuring the deal, performing due diligence, drafting contracts and transitioning the practice. As a famous golf pro once said, "Amateurs make amateurs, amateurs." Get professional help.

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